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SUBJECT: 2008 INVESTMENT CLIMATE STATEMENT - ESTONIA

REF: 07 STATE 158802
¶1. (U) The following is the 2008 Investment Climate Statement for Estonia, keyed to questions in reftel.
¶2. (U) A.l. Openness to Foreign Investment

Since joining the EU in 2004, the Estonian government has sought to maintain liberal policies in order to attract investments that could produce exports. All foreign investors are treated on an equal footing with local investors. While the GOE's focus in the mid-1990s was to attract actively foreign direct investment (FDI) into Estonia, at present it is prioritizing the finding of new export markets for Estonian goods and services.

Estonia's government does not screen foreign investments. It does, however, establish requirements for certain sectors. These requirements are not intended to restrict foreign ownership but rather to regulate it and establish clear ownership responsibilities. Licenses are required for a foreign investor to become involved in the following sectors: mining, energy, gas and water supply, railroad and transport, waterways, ports, dams and other water-related structures and telecommunications and communication networks. The Estonian Central Bank issues licenses for foreign interests seeking to invest in or establish a bank. Government review and licensing have proven to be routine and non-discriminatory.

Estonia's openness to foreign direct investment extended to its 1993-2001 privatization program, which is now complete. Only a small number of enterprises -- the country's main port, the power plants, the postal system, and the national lottery -- remain state-owned. In January 2007, the government also repurchased the 66 percent of shares of the Estonian Railway which had been in the hands of private investors since 2001, claiming the need to maintain control of this key part of Estonia's national infrastructure.

During the last decade, Estonia has been one of the leading countries in Central and Eastern Europe in terms of inward investment per capita. Companies partly or wholly owned by foreigners account for one-third of Estonian GDP and over 50 percent of the

country's exports. By the end of Q2 2007, the cumulative stock of FDI amounted to USD 14.02 billion. About 30 percent of FDI has been invested in financial intermediation and about the same amount in real estate, renting and business activities. Manufacturing is in third place with 16 percent of total FDI. Wholesale and retail trade has attracted 13 percent of the foreign direct investment stock.

Some general facts concerning foreign direct investment inflows into Estonia include:

- In 1995-1996, the majority of foreign direct investment was privatization-related;
- There is a trend towards cross-border acquisitions;
- Greenfield investments are increasingly rare;
- From its 10-11 percent GDP growth rates of 2005-06, Estonia is slowing to an estimated 7.3 percent in 2007 and less than 5 percent in 2008.

A.2. Conversion and Transfer Policies

Estonia has been under a currency board arrangement since 1992. Initially pegged to the German mark, the Estonian kroon (EEK) has been fixed to the euro at EEK 15.65 since January 1999. Estonia joined the Exchange Rate Mechanism (ERM) II in June, 2004.

The Estonian currency has no restrictions on its transfer or conversion. Similarly, there are no restrictions, limitations or delays involved in converting or transferring funds associated with an investment (including remittances of investment capital, earnings, loan repayments, or lease payments) into other currencies at market rates. There is no limit on dividend distributions as long as they correspond to a company's official earnings records. If a foreign company ceases to operate in Estonia, all its assets may be repatriated without restriction. These policies are all long-standing; there is no indication that they will be altered in the future. Foreign exchange is readily available for any purpose.

A.3. Expropriation and Compensation

Private property rights are observed in Estonia. There have been no known cases of expropriation or nationalization since the country regained its independence in 1991.

A.4. Dispute Settlement

Investment disputes concerning U.S. or other foreign investors and Estonia are rare. Estonia's judiciary is independent and insulated from government influence. Property rights and contracts are enforced by the courts.

Estonia's commercial law has proven extremely effective and is often cited as one of the components of Estonia's successful economic reforms. The Commercial Code, as a part of the overall commercial law, is consistently applied. The Obligation Law, enacted in 2002, is the basis for all commercial agreements. A Bankruptcy Act was adopted in 2004. The full text of these laws can be found from: http://www.legaltext.ee/en/ Estonia has been a member of the International Center for the Settlement of Investment Disputes (ICSID) since 1992, and a member of the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards since 1993.

Recognition of court rulings of EU Member States is regulated by EU legislation.

The Arbitration Court of the Estonian Chamber of Commerce and Industry is a permanent arbitration court which settles disputes arising from contractual and

other civil law relationships, including foreign trade and other international economic relations.

A.5. Performance Requirements/Incentives

A fundamental principle of Estonia's economic policy is equal treatment of foreign and domestic capital. No special investment incentives are available to foreign investors, nor is any favored treatment accorded them. Similarly, there are no specific performance requirements for foreign investments that differ from those required of domestic investments.

Estonia continues to refine its immigration policies and practices. U.S. citizens are exempt from the quota regulating the number of immigration and residence permits issued, as are citizens of the EU and Switzerland.

Estonia's has a long-standing system of low, simple, flat-rate taxes, in particular, a 21 percent income tax which is set to be reduced one percent per year until it reaches 18 percent in 2011. To encourage companies to expand their business, all reinvested profits are exempted from corporate income tax. However, any redistributed profits, such as dividends, are taxed at 21 percent in 2008. This tax strategy was designed to promote business and accelerate economic growth by making additional funds available for investment. During accession talks, the EU gave Estonia a transition period of seven years (the end of 2008) by which time this tax policy will have to be brought into accordance with EU tax directives governing parent-daughter subsidiary relationships.

Generally, the government does not impose 'offset' requirements on major procurements.

A.6. Right to Private Ownership and Establishment

Private ownership and entrepreneurship are respected in Estonia. In most fields of business, participation by foreign companies or individuals is unrestricted. As provided for by the Law on Foreign Investments, foreign investors have the same rights and obligations as Estonian citizens. Foreign investors may purchase buildings and land for production purposes and establish, buy, and fully own companies.

Government approval is required for foreign investment and participation in only a handful of sectors (see section A.1).

Competitive equality is the official standard applied to private enterprises in competition with public enterprises. Private companies do not face discrimination in relation to state-owned companies.

A.7. Protection of Property Rights

Secured interests in property are recognized and enforced. Mortgages are quite common for both residential and commercial property and leasing as a means of financing is widespread and efficient.

The legal system protects and facilitates acquisition and disposition of all property rights, including land, buildings, and mortgages. The long and complicated process of property restitution (begun when the Principles of Ownership Reform Act came into force June 20, 1991) is almost complete, including the area of non-residential real properties.

The Estonian legal system adequately protects property rights, including intellectual property, patents, copyrights, trademarks, trade secrets and industrial design. Estonia adheres to the Berne Convention, WIPO and TRIPS, the Rome Convention and the Geneva Convention on the Protection of the Rights of Producers. Estonian legislation fully complies with

EU directives granting protection to authors, performing artists, record producers, and broadcasting organizations. In 2002, Estonia withdrew its reservation on Article 12 of the Rome Convention, thus extending equal treatment to domestic and foreign phonogram producers. (Note: However, because the U.S. is not a member of the Rome convention, equal treatment is not extended to U.S. phonogram producers under this agreement. End Note.)

A.8. Transparency of the Regulatory System

The Government has set out transparent policies and effective laws to foster competition and establish "clear rules of the game." However, due to the small size of Estonia's commercial community, instances of favoritism are not uncommon despite regulations and procedures designed to limit them.

Tax, labor, health and safety laws and policies have been crafted to encourage investment. They appear to have been successful, given the relatively high level of foreign direct investment per capita.

All proposed laws and regulations are published for public comments on the website: http://eoigus.just.ee/ There are also websites www.osale.ee and http://tom.riik.ee/ where the public can comment on draft laws and propose changes to the government regulations.

Estonia's bureaucratic procedures are generally far more streamlined and transparent than those of other countries in the region.

International institutions and organizations give Estonia's economic policies high marks. The U.S.-based Wall Street Journal/Heritage Foundation's 2007 Index of Economic Freedom ranked Estonia 12th in the world. The index is a composite of scores in monetary policy, banking and finance, black markets, wages and prices. Estonia scores highly on this scale for investment freedom, fiscal freedom, financial freedom, property rights, business freedom, and monetary freedom.

A.9. Efficient Capital Markets and Portfolio Investment

Estonia's financial sector is modern and efficient. Government and Central Bank policies facilitate the free flow of financial resources, thereby supporting the flow of resources in the product and factor markets. Credit is allocated on market terms and foreign investors are able to obtain credit on the local market. The private sector has access to an expanding range of credit instruments similar in variety to those offered by banks in Estonia's Nordic neighbors Finland and Sweden.

Legal, regulatory, and accounting systems are transparent and consistent with international norms.

The Security Market Law complies with EU requirements and enables EU securities brokerage firms to deal in the market without establishing a local subsidiary. In 2002, the Helsinki Stock Exchange (Finland) bought a controlling interest in the Tallinn Stock Exchange, merging the two entities and making the smaller Estonian market more accessible to foreign investors.

Estonia's banking system has consolidated rapidly. Total assets of the commercial banks are approximately USD 27 billion at the end of 2007. Nine regional banks control the market. Four representative offices of foreign banks had been established by December ¶2007. More info: http://www.pangaliit.ee/eng/Info/

The Scandinavian-owned Estonian banking system is

modern and efficient, encompassing the strongest and best-regulated banks in the region. These provide both domestic and international services (including Internet and telephone banking) at very competitive rates. Both local and international firms provide a full range of financial, insurance, accounting, and legal services. Estonia has a highly advanced Internet banking system: more than 80 per cent of residents make their everyday transactions via Internet banking.

The Central Bank and the government hold no shares in the banking sector.

In 2001 the Estonian government created a consolidated Financial Supervisory Authority (FSA) under the auspices of the Central Bank. The Authority is an agency with autonomous competence and a separate budget. The FSA conducts financial supervision on behalf of the state and is independent in the conduct of financial supervision. The Authority was established to enhance the stability, reliability, transparency, and efficiency of the financial sector, to reduce system risks, and to prevent the use of the financial sector for criminal purposes.

A.10. Political violence

Politically motivated damage to projects or installations is extremely rare. However, in April 2007, following the government's decision to relocate a Soviet-era statue from downtown Tallinn to a nearby cemetery, there were two days of rioting and looting of shops in Tallinn. A subsequent Russian Federation boycott of Estonian goods, and disruption of rail and truck transit into Estonia had a negative impact on some local companies. For a few days in early May, cyber criminals targeted Estonian banks and government websites with massive denial-of-service (DOS) attacks, which cost several million Euros in estimated lost revenues. The industrial sector most impacted was transit. By year's end, the Port of Tallinn announced that its cargo volumes for 2007 were down 13 percent from the previous year. The government has estimated the overall economic loss to Estonia of Russian restrictions of trade during May-December as between one-half and one percent of GDP.

A.11. a. Corruption

Estonia has laws, regulations, and penalties to combat corruption and, while corruption is not unknown, it has generally not been a major problem faced by foreign investors. However, foreign companies have found it difficult to become part of the local commercial community because many Estonian executives have known one another since childhood and often help one another out in ways that make it difficult for outsiders to compete effectively.

Both offering and taking bribes are criminal offenses which can bring imprisonment of up to five years. While payments that exceed the services rendered are not unknown, and conflict of interest is not a well-understood issue, surveys of American and other non-Estonian businesses have shown the issues of corruption and/or protection rackets are not a major concern for these companies.

In 2004, the government of former Prime Minister Juhan Parts, who ran on an anti-corruption platform in 2003, instituted the "Honest State" program, which included specific policies to reduce the risk of corruption in government. These included auditing local governments (widely seen as the greatest source of corruption in Estonia), requiring public servants to file electronic declarations of their economic interests, setting up a National Ethics Council, increasing the number of specialized investigators and prosecutors who focus on

corruption, and setting up an anonymous hotline for people to report corruption cases.

The Security Police Board has shown its capacity to deal with corruption offences and criminal misconduct, leading to the conviction of several high-ranking state officials. Estonia co-operates in fighting corruption at the international level and is a member of GRECO (Group of States Against Corruption).

Estonia began as a full participant in the OECD Working Group on Bribery in International Business Transactions (the Working Group) in June 2004, and deposited its instruments of accession on November 23, ¶2004. The Convention entered into force in Estonia on January 22, 2005.

In 2007, Transparency International ranked Estonia 28th out of 179 countries on its Corruption Perceptions Index.

A.12. Bilateral Investment Agreements

Estonia has investment promotion and protection agreements with the Belgium-Luxembourg Economic Union, China, Czech Republic, Denmark, Finland, Great Britain and Northern Ireland Greece, Israel, Italy, Latvia, Lithuania, Netherlands, Norway, Poland, Spain, Sweden, Switzerland, Turkey, Ukraine, UK and the United States. A Bilateral Taxation Treaty with the U.S. came into force on January 1, 2000.

A.13. OPIC and Other Investment Insurance Programs

Estonia is a member of the Multilateral Investment Guarantee Agency.

Estonia joined the Exchange Rate Mechanism II on June 28, 2004. The Estonian kroon is fixed against the euro at 1 EUR = 15.6466 EEK.

A.14. Labor

Estonia has a very small population - only 1.4 million people. The Estonian labor force is highly skilled and well educated. There are 14 universities, 19 higher education colleges and 114 technical secondary institutions, all combining to produce graduates with adequate technical skills, and fluent in English, Russian, German and other languages. Over 17 percent of the population has received post-secondary education; this number is growing rapidly.

The average monthly Estonian salary at the end of 2007 was USD 950. Annual economic growth above ten percent in recent years, rising inflation, and free movement of labor to other EU countries have driven up salaries in most sectors. Average gross wage growth in 2006 was 16.2 percent, and the increase for 2007 is expected to be approximately 20 percent.

The influence of trade unions, which tend to take a cooperative approach to industrial relations, is increasing. Estonia adheres to ILO Conventions protecting workers' rights.

With an aging population and a negative birth rate, Estonia, like many other countries of Central and Eastern Europe, faces serious demographic challenges affecting its long term supply of labor. Improving labor efficiency is a key focus for Estonia in the short-to-mid term. It is becoming increasingly hard to find a pool of blue collar workers to start up small or medium-sized manufacturing enterprises that requiring significant manpower.

A.15. Foreign Trade Zones/Free Ports

According to the Customs Act, free zones can be established on the customs territory by order of the government. Goods in a free zone are considered as being outside the customs territory, for the purposes of import and export duties. As a rule, customs procedures are not applied to goods in a free zone. In free zones, VAT and excise duties (as well as possible fees for customs services) do not have to be paid on goods brought in for later re-export.

In Estonia, there are free zones at the Muuga port (near Tallinn), the Sillamae port (northeast Estonia), and in Valga (southern Estonia). All free zones are open for FDI.

The main supervisory authority responsible for monitoring the movement of goods in or out of free zones is the Estonian Tax and Customs Board (governed by the Ministry of Finance). There are ID requirements for companies and individuals using the zone. The U.S. Department of Homeland Security (Coast Guard) has inspected Estonia's ports and determined that the Republic of Estonia has substantially implemented the International Ship and Port Facility Security (ISPS) Code at all facilities visited.

A.16. Foreign Direct Investment Statistics

By the end of Q2 2007, the cumulative stock of foreign direct investment amounted to USD 14 billion. 29.8 percent of FDI has been invested in financial intermediation. This sector is followed by real estate renting and business activities (29.5), and manufacturing (15.7).

In 2006, the inflow of FDI was approximately USD 1.7 billion, or 10 percent of GDP.

Scandinavian countries are the largest foreign direct investors in Estonia. Sweden has 40 percent of the total, followed by Finland with 25 percent, and the Netherlands with 5 percent. The United States accounts for 1.7 percent of foreign direct investment stock. (10th overall)

For the value of FDI (position, stock, and flows in recent years by the commodity group, as well as country of origin) please go to:

http://www.eestipank.info/pub/en/dokumendid/s tatistika /maksebilanss/statistika/statistika.html?objI d=292616

The ten selected largest FDI companies in Estonia in terms of total investment:

¶1. Galvex
Country of origin: Luxembourg
Sector of operation: steel galvanizing

¶2. Hansapank
Country of origin: Sweden, Finland, UK, Austria, Switzerland, Luxembourg
Sector of operation: banking

¶3. Estonian Telecom
Country of origin: Sweden/USA/Netherlands
Sector of operation: telecommunication

¶4. Sampo Bank
Country of origin: Finland
Sector of operation: banking

¶5. Eurodek Tallinn
Country of origin: Switzerland
Sector of operation: transportation

¶6. SEB Eesti Uhispank
Country of origin: Sweden

Sector of operation: banking

¶7. GHI Group/Atlantic Veneer Corporation
Country of origin: USA
Sector of operation: production of veneer

¶8. Pro Kapital Group
Country of origin: Italy/Ireland
Sector of operation: real estate

¶9. Kunda Nordic Cement AS
Country of origin: Finland, IPC
Sector of operation: cement production

¶10. HK Ruokatalo OY
Country of origin: Finland
Sector of operation: food industry

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